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BEFORE THE ARIZONA CORPORATION COMMISSION

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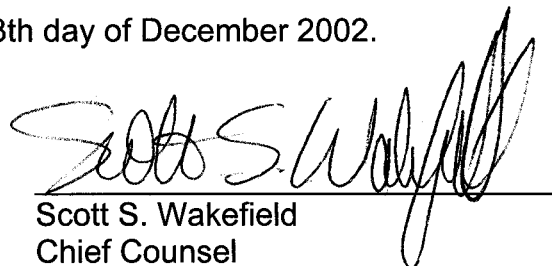
Docket No. E-01345A-02-0707

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR AN ORDER OR ORDERS
AUTHORIZING IT TO ISSUE, INCUR, OR
ASSUME EVIDENCES OF LONG-TERM
INDEBTEDNESS; TO ACQUIRE A
FINANCIAL INTEREST OR INTERESTS IN
AN AN AFFILIATE OR AFFILIATES; TO
LEND MONEY TO AN AFFILIATES OR
AFFILIATES; AND TO GUARANTEE THE
OBLIGATIONS OF AN AFFILIATE OR
AFFILIATES

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Direct Testimony of Marylee Diaz Cortez, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 13th day of December 2002.


Scott S. Wakefield
Chief Counsel

Arizona Corporation Commission
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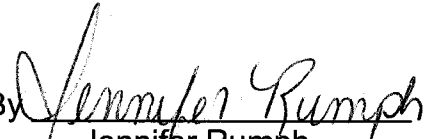
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3 IN THE MATTER OF THE ARIZONA PUBLIC SERVICE COMPANY'S RATE
4 APPLICATION

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6 DOCKET NO. E-01345A-02-0707
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16 DIRECT TESTIMONY
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18 OF
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20 MARYLEE DIAZ CORTEZ
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31 ON BEHALF OF
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33 THE
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35 RESIDENTIAL UTILITY CONSUMER OFFICE
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43 DECEMBER 13, 2002
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INTRODUCTION

Q. Please state your name for the record.

A. My name is Marylee Diaz Cortez. I am a Certified Public Accountant. I am the Chief of Accounting and Rates for the Residential Utility Consumer Office (RUCO) located at 1110 W. Washington, Suite 220, Phoenix, Arizona 85007.

Q. Please state your educational background and qualifications in the field of utility regulation.

A. Appendix I, which is attached to this testimony, describes my educational background and includes a list of the rate case and regulatory matters in which I have participated.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to present recommendations resulting from my review and analysis of Arizona Public Service Company's (Company or APS) application for approval of the issuance of long-term indebtedness and examine the transaction as it affects APS's parent company, Pinnacle West Capital Corporation (PWCC) and its unregulated generation subsidiary, Pinnacle West Energy Corporation (PWEC).

1 Q. How is your testimony organized?

2 A. First, I will provide some historical background information related to
3 Arizona's efforts at restructuring its electric industry. Next, I will discuss
4 how those historical events have led us to the financing issue that is the
5 subject of this docket. I will identify other problems (beyond the PWEC
6 plant financing issue) that have arisen because a competitive retail electric
7 market has failed to develop in the Southwest. Finally, I will discuss the
8 need for a cohesive comprehensive solution to the problems that have
9 arisen because a functional competitive electric market has failed to
10 develop and make recommendations how to achieve those solutions.

11

12 **BACKGROUND**

13 Q. Please discuss the history of Arizona's efforts to restructure the regulation
14 of the electric industry and move to a competitive electric market.

15 A. In May of 1994 the ACC Staff opened Docket No. RE-00000C-94-0165,
16 *In the Matter of the Competition in the Provision of Electric Services*
17 *Throughout the State of Arizona*, to study and consider electric
18 restructuring for the State of Arizona. The Commission held workshops,
19 public meetings, and hearings on the issue and adopted new rules A.A.C
20 R14-2-1601 through R14-2-1616 (Competition Rules) on December 26,
21 1996 in Decision No. 59943. Several of the parties in the competition
22 docket challenged the Competition Rules in the state courts. The
23 Commission scheduled additional procedures (workshops, hearings,

1 public meetings) regarding the Competition Rules. In September of 1999
2 the Commission adopted revised Competition Rules.

3
4 Q. What did the revised Competition Rules provide?

5 A. The revised Competition Rules contained the following pertinent
6 provisions:

- 7
- 8 1) All customers shall be eligible to obtain competitive electric services
9 no later than January 1, 2001;
 - 10 2) All competitive generation assets and competitive services shall be
11 separated from the regulated utility prior to January 1, 2001. Such
12 separation shall be to an unaffiliated third party or to a separate
13 corporate affiliate(s);
 - 14 3) After January 1, 2001, power purchased by a regulated distribution
15 company for Standard Offer service shall be acquired from the
16 competitive market through prudent, arm's length transactions, and
17 with at least 50% through a competitive bid process.¹
- 18

19 Q. Please continue discussing the history of electric restructuring in Arizona.

20 A. In October 2001, APS filed an application for a partial variance from the
21 Competition Rules that required competitive procurement of power for
22 Standard Offer customers, and for approval of a purchased power

¹ The 2001 dates referred to in items 2 and 3 were extended to January 1, 2003 for APS in Decision No. 61973.

1 agreement with the APS affiliate to which it was planning to transfer its
2 generation assets. APS explained that the waiver application was
3 necessary because of the instability of western wholesale electricity
4 markets and imprudency of competitive acquisition of power in such a
5 market.

6
7 In January and February 2002, the ACC Commissioners each issued
8 letters seeking information pertaining to the restructuring of Arizona's
9 electric industry. A new docket (E-00000A-02-051) was opened to
10 examine electric restructuring issues, and to examine current events and
11 how such events impacted the Competition Rules as well as the
12 restructuring settlement agreements.

13
14 Q. Did the Commission grant APS its variance request?

15 A. Prior to considering the APS partial variance application and purchased
16 power agreement, the Commission ordered that certain threshold issues
17 (primarily wholesale market power and the transfer of generation assets)
18 be considered in a "Track A" proceeding. Additionally, the Commission
19 instructed the consideration of competitive solicitation in a "Track B"
20 proceeding. A hearing on the Track A issues was held in June 2002 and a
21 decision issued in September 2002. Track B issues have been examined
22 in workshops and hearings. A Commission decision is pending.

1 On September 10, 2002 Decision No. 65154 was issued on the Track A
2 proceeding. The order raised concerns that APS and TEP have market
3 power in specific areas; that the wholesale electricity market applicable to
4 Arizona is poorly structured and susceptible to possible malfunction and
5 manipulation. The order concluded that the requirement that regulated
6 electric utilities transfer their generation assets to others is not in the
7 public interest at this time, and waives compliance with that rule.
8

9 **IMPACT OF DYSFUNCTIONAL MARKETS**

10 Q. How has APS been effected by the dysfunctional wholesale markets?

11 A. The ACC moved to protect customers from the dysfunctional markets by
12 waiving/staying certain elements of the Competition Rules. Specifically, in
13 Decision No. 65154 the Commission waived the requirement for APS to
14 divest its generation assets.
15

16 Q. Why does the reversal of the divestiture requirement necessitate APS's
17 financing request?

18 A. The APS financing application states, and RUCO agrees, that APS's
19 generation subsidiary, Pinnacle West Energy Corporation (PWEC) is not
20 creditworthy on a stand-alone basis. PWEC is incapable of securing
21 financing on a stand-alone basis, given that Decision No. 65154 modified
22 the Competition Rules so that APS could not divest generation to PWEC.
23 The application requests ACC authority for APS to issue long-term debt,

1 which it would in turn loan to PVEC to support the long term financing of
2 the PVEC owned generation assets. In the alternative the application
3 requests authority for APS to guarantee the long-term indebtedness to
4 support the PVEC generation assets.

5
6 Q. Are PVEC's credit problems attributable solely to the fact that it will not
7 acquire the APS owned generation?

8 A. No. A number of factors are contributing to the problem. Many of these
9 factors have arisen from the conditions that led the ACC to vacate the
10 divestiture requirement.

11
12 Market conditions are not good for the energy sector. Near term power
13 prices have declined over the past year or so and the power market in
14 Arizona is over-built. Under such conditions, a stand-alone start up
15 merchant generator with 2000 megawatts of uncommitted resources is
16 considered high risk and unable to achieve an investment grade rating.
17 APS acknowledges that under the current environment (i.e., no APS
18 divestiture, glut of Arizona new generation plants, price of power, change
19 in the status of California restructuring, the Enron market manipulations,
20 etc.) PVEC would never have been created, nor would PVEC have built
21 the generation assets it now holds.

1 APS further indicated in testimony and responses to data requests that the
2 sale of the PWEC generation assets to a third party at this juncture would
3 be "punitive". The economic value of the generation assets in today's
4 market is significantly less than PWEC's cost to build these assets. The
5 PWEC generation assets are therefore uneconomic under current
6 circumstances.

7
8 Q. Is the uneconomic nature of the PWEC assets solely attributable to the
9 modifications that Decision No. 65154 made to the Competition Rules?

10 A. No. PWEC's assets are uneconomic due to the same market factors
11 discussed above that led the ACC to modify the Competition Rules in
12 Decision No. 65154. While these factors are certainly important to
13 understand, it is more important to recognize that because the assets are
14 uneconomic a regulatory solution will be necessary for APS to effectively
15 continue to serve the public needs.

16
17 Q. Why is the uneconomic state of the PWEC assets of concern to APS and
18 APS ratepayers?

19 A. APS would not be concerned if PWEC were a stand-alone merchant
20 generator whose venture failed and went bankrupt due to business risk.
21 However, the uneconomic state of the PWEC assets is a regulatory
22 concern because PWEC was created as a result a series of regulatory
23 rules and decisions to move APS and the electric industry to competition.

1 Unfortunately, because a functionally competitive electric market has not
2 developed, it is now necessary to rebuild the regulatory framework of the
3 electric industry.

4
5 Allowing PWECC, and as a result PWCC, to default on its debt and enter
6 bankruptcy is not in the public interest. APS, notwithstanding potential
7 ravages to its affiliates, must remain sound to serve the public interest. It
8 is therefore far more prudent to design a rescue plan to prevent financial
9 collapse of PWECC rather than stand aside, watch its collapse, and attempt
10 to clean up the wreckage afterward.

11
12 Further, the PWECC generation assets are not necessarily uneconomic for
13 all time. Under evolving circumstances (i.e. load growth, a return to
14 regulation, a reallocation of resources, etc.) the PWECC assets could
15 become economic. Given this potential it would be unwise at this juncture
16 to allow the collapse of PWECC and loss of the generation assets for
17 pennies on a dollar.

18
19 In summary, rebuilding the electric industry to a regulated framework will
20 be far less costly if reconstruction begins prior to the ultimate collapse.

1 Q. To what factors does APS attribute the uneconomic state of the PWEC
2 generation assets?

3 A. In response to RUCO data request no. 3.5, which asked, "How much of
4 the PWCC problem in refinancing the PWEC assts is attributable to the
5 general credit markets for energy related companies and how much is
6 attributable to the ACC's dramatic reversal of course on divestiture?"

7 APS responded as follows:

8 The problem is clearly attributable to both, and although the
9 ACC's reversal of course was the precipitating event, it is not
10 particularly relevant or helpful at the present time to attempt
11 in some way to "allocate" responsibility for a single outcome
12 to any one of its several contemporaneous causes, nor has
13 APS attempted to do so. PWCC had planned to finance at
14 PWEC, which after divestiture, would have been an
15 investment grade company. Without investment grade credit
16 ratings, PWEC is not able to access the capital markets.
17 This then leaves the parent in the position of having to do
18 the refinancing, which in turn could lead to credit rating
19 downgrades. It is nevertheless also true that the general
20 credit markets for energy related companies have been both
21 volatile and shrinking for the past several months. There is a
22 clear bifurcation of market participants in terms of credit
23 spreads on existing and newly issued debt. Companies with
24 fundamentally sound business models and little regulatory
25 risk are still able to access the credit markets, albeit at a
26 higher cost than earlier in the year. However, companies
27 with any sort of material regulatory or business uncertainty
28 (real or perceived) have been issuing debt at what would
29 previously have been described as non-investment grade
30 levels, if they are able to access the credit markets at all.

31
32
33

1 **RECOMMENDATION**

2 Q. Do you believe the APS proposed financing of the PWEC assets is the
3 appropriate solution to the dysfunctional status of the western energy
4 markets?

5 A. No. The APS proposed financing is merely a stopgap measure, which will
6 serve only to prevent PWEC from defaulting on its short-term debt
7 obligations and going into bankruptcy. What really is needed is a
8 cohesive comprehensive plan to rebuild the regulatory paradigm and
9 return the electric industry in Arizona to functional viability. The effect of
10 Decision No. 65154 was not simply to stay divestiture, but to stay a move
11 to reliance on a competitive wholesale electric market. The following
12 language from Decision No. 65154 makes it clear a stay of competition in
13 its entirety is intended:

14 In retrospect it was a good idea to delay divestiture and
15 competitive procurement in the APS and TEP Settlement
16 Agreements, given what has happened in the last two or so
17 years, including the experience in California; the market
18 volatility and illiquidity; and the lack of public confidence in
19 the transition to electric deregulation and the ability of
20 regulators to prevent price spikes, ensure reliable service,
21 and prevent bankruptcies. Even today, there is not
22 agreement amongst economists, much less regulators, as to
23 why what happened in California, happened, and how to
24 prevent a similar or related occurrence.

25
26 It is clear that the Commission and all parties expected
27 benefits from retail competition, yet there is no active retail
28 competition, so actual benefits are still unknown. It is said
29 that consumers will benefit from wholesale competition, but
30 not without the proper market structure and regulatory
31 framework that will support it.

1 Q. Does APS itself recognize that its proposed financing is merely a stopgap
2 and that ultimately we need to build a regulatory framework that will return
3 the electric industry to functionality?

4 A. Yes. APS states at page 2 of its application that the financing application
5 is just one step in the process of repairing the damage to the Company
6 from the transitioning to and then the ultimate abandonment of a
7 competitive electric industry.

8

9 Q. Why is it important to rebuild the electric industry framework and address
10 the costs that were incurred in pursuit of a competitive industry sooner
11 rather than later?

12 A. A significant amount of costs have already been expended on the
13 transitioning to a competitive electric industry. As I testified in the Track A
14 restructuring procedure, pursuant to the APS settlement agreement and
15 the Financial Accounting Standard Board (FASB 71) APS has been
16 deferring its cost of transitioning to a competitive electric industry for future
17 recovery. Every day that the process of transitioning to a competitive
18 electric market goes on, the costs continue to amass. In other words, the
19 cost meter continues to tick as we speak. Therefore, the sooner the
20 necessity of a regulatory reconstruction is recognized and acknowledged,
21 the sooner the transition cost accruals will turn off. The piecemeal "step"
22 procedure to mitigating the damages caused by a failed competitive
23 electric industry, as proposed in the APS financing application, will merely

1 create additional problems, costs, and ultimately prolong and impede the
2 necessary rebuilding of Arizona's electric regulatory framework.

3
4 Q. What issues will need to be examined and ultimately resolved as part of a
5 regulatory reconstruction program?

6 A. The APS emergency financing order² had the effect of APS assuming
7 financial liability for assets that it does not own and over which this
8 Commission does not have jurisdiction. This is an extraordinary measure
9 that in the absence of extraordinary circumstances never would have been
10 considered. Accordingly, those assets now need to be transferred to APS
11 and Commission jurisdiction. RUCO recommends that the Commission's
12 approval of the Permanent Financing be conditioned on APS filing an
13 application for the transfer of the PWE generation assets to APS within
14 45 days of the issuance of a decision in this docket.

15
16 Once the PWE generation assets are reunited with the APS debt a full
17 examination of APS's cost of service in the context of a rate case is
18 necessary. An APS rate case is scheduled for the near term. Decision
19 No. 61978 requires APS to file a general rate case by June 30, 2003.

20
21 The scheduled rate case is timely since APS has not had a full rate
22 investigation in over ten years, calling to question the reasonableness of

² Decision No. 65434, dated December 3, 2002.

1 today's rates. The rate case must 1) look at the costs that have been
2 incurred to pursue a competitive electric industry and 2) determine an
3 appropriate allocation of those costs. The rate case can determine which
4 portion of the PWEC generation is used and useful and eligible for rate
5 base treatment and which is uneconomic and therefore not eligible for rate
6 base treatment. The rate case will ultimately resolve the manner in which
7 uneconomic costs might be allocated among ratepayers and
8 shareholders.

9
10 Arizona Administrative Code sections R14-2-1601 through R14-2-1618
11 should be revised consistent with the electric regulation reconstruction.
12 Decision No. 65154 recognizes the need for a comprehensive review of
13 the Competition Rules and has already instructed Staff to open a
14 rulemaking docket to address any required changes to the rules.

15
16 Q. So you are recommending approval of the Permanent Financing?

17 A. Yes. However, this recommendation is dependent on the recognition that
18 the financing is simply the first step to the ultimate reconstruction of
19 electricity regulation. Without this understanding the proposed financing is
20 not in the public interest, as it would assign APS a \$500,000,000 liability
21 for assets to which it does not hold title. Clearly, such an arrangement
22 would not serve captive ratepayers interests in the long run.

1 Q. Does that conclude your direct testimony?

2 A. Yes.

3

4

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7